International View

Employee Benefits Accounting

December 31, 2020 edition

Discount rates stable in December and assets show good returns

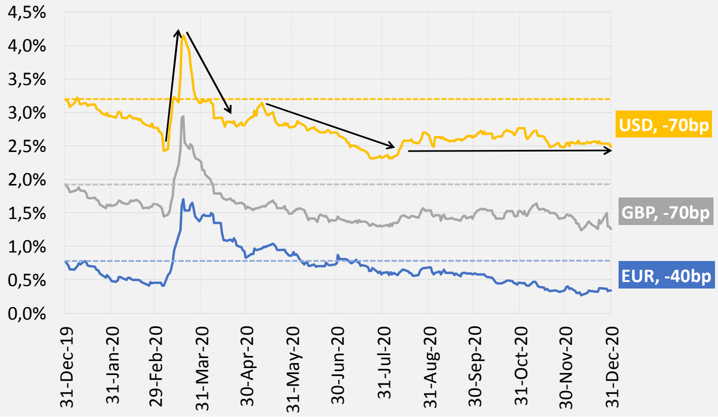
In December, most financial markets showed good performance, supported upwards by the first Covid-19 vaccines being administered, and a no-deal Brexit being avoided. However more contagious virus variants and increases in cases adds to uncertainty. In December, bond yields remained steady in US and Eurozone but dropped 20bp in the UK. Between December 31, 2019 and December 31, 2020, USD discount rate went down 70bp, GBP rate is 60bp down, and EUR rate is 50bp lower.

On average, **discount rates** are **down 40bp** from last year-end in the main currency zones, and **unfunded liabilities** could therefore be **6% higher** than last year-end.

Funded liabilities still suffer from the **equity** crash in March, although the strong performance in the last two months of 2020 contributed to a further recovery of the assets.

Discount rate evolution 31-Dec-2019 until 31-Dec-2020 (in %)

(Iboxx Corporate AA bond yields for duration of 10+ years)



Discount rates mostly lower than at YE19

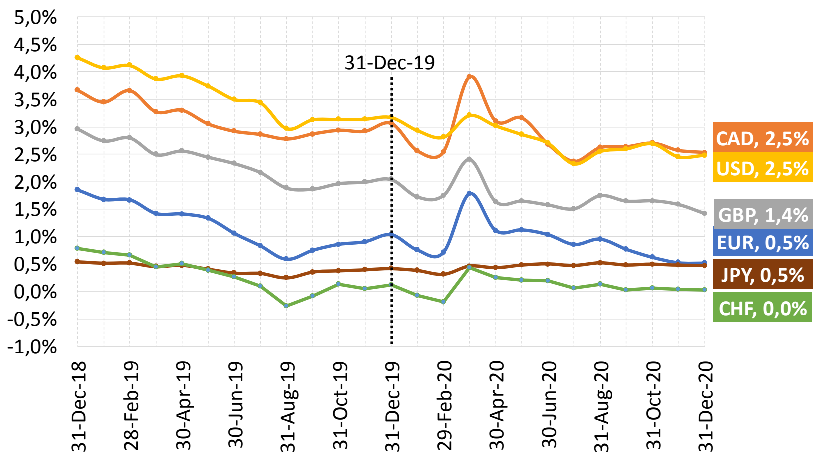
Bonds yields determine the discount rate of your company's pension liabilities under IFRS and US GAAP accounting. Early 2020, in fear of the economic consequences of the Covid-19 outbreak in Asia, bond yields fell globally as investors fled to the safety of high quality bonds. Yields spiked globally in March with panic sales of equities and corporate bonds when the worldwide impact of the virus became clear and investors worried about corporate profitability.

The pandemic's economic effects have been eased by central banks' measures, public finance support and positive vaccine trial outcomes. The confidence and stability this brought to the financial markets caused equities and bonds to make significant recovery.

In December 2020 most discount rates remained stable, UK being a notable exception. Compared to December 31, 2019 most discount rates are significantly lower.

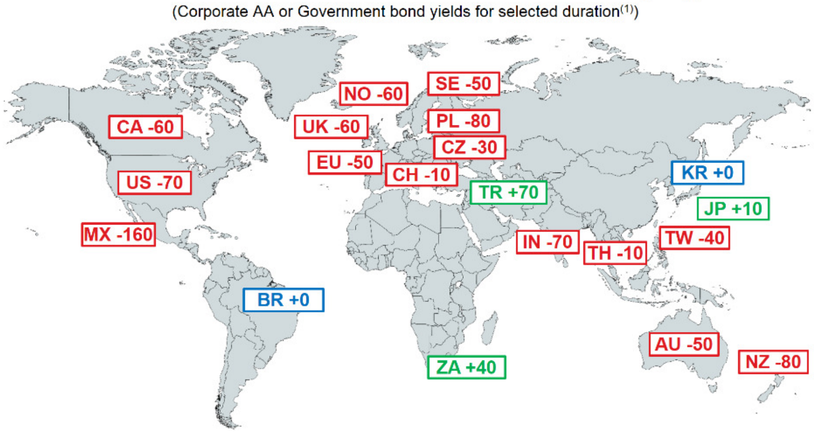
Discount rate evolution 31-Dec-2018 until 31-Dec-2020 (in %)

(Aon Corporate AA bond yields for selected duration(1))



Discount rate evolution 31-Dec-2019 until 31-Dec-2020 (in bp)

(Corporate AA or Government bond yields for selected duration(1))



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Unfunded liabilities around 6% higher in 2020

Unfunded employee benefit liabilities could increase on average 6% in the main currency zones due to changes in discount rates since year-end 2019. In the other currency zones, the picture is broadly similar.

	Selected	Discount rate				Year-to-date increase/(decrease)	
	duration[1]	31-Dec-18	31-Dec-19	30-Nov-20	31-Dec-20	Discount rate	Unfunded liability
Main currency zones							
USA	12	4,3%	3,2%	2,5%	2,5%	(0,7%)	8,5%
Eurozone	15	1,8%	1,0%	0,5%	0,5%	(0,5%)	7,7%
UK	20	3,0%	2,0%	1,6%	1,4%	(0,6%)	12,5%
Canada	15	3,7%	3,1%	2,6%	2,5%	(0,6%)	9,1%
Japan	10	0,5%	0,4%	0,5%	0,5%	0,1%	(1,0%)
Switzerland	15	0,8%	0,1%	0,0%	0,0%	(0,1%)	1,5%
					Average main currency zones	**(0,4%)**	**6,4%**
Other currency zones							
Australia	10	3,7%	2,5%	2,0%	2,0%	(0,5%)	5,0%
Brazil	10	4,8%	3,1%	3,4%	3,1%	0,0%	0,0%
Czechia	10	1,9%	1,6%	1,3%	1,3%	(0,3%)	3,0%
India	10	7,5%	6,9%	6,2%	6,2%	(0,7%)	6,8%
Mexico	10	8,8%	6,9%	5,6%	5,3%	(1,6%)	16,3%
New Zealand	10	2,4%	1,8%	0,5%	1,0%	(0,8%)	8,2%
Norway	10	2,6%	2,3%	1,5%	1,7%	(0,6%)	6,1%
Poland	10	2,8%	2,1%	1,2%	1,3%	(0,8%)	8,2%
South Africa	10	9,8%	9,6%	10,6%	10,0%	0,4%	(3,6%)
South Korea	10	2,6%	2,3%	2,3%	2,3%	0,0%	0,0%
Sweden	10	1,7%	1,2%	0,6%	0,7%	(0,5%)	5,1%
Taiwan	10	1,0%	0,7%	0,3%	0,3%	(0,4%)	4,1%
Thailand	10	2,6%	1,5%	1,5%	1,4%	(0,1%)	1,0%
Turkey	10	16,0%	11,7%	11,8%	12,4%	0,7%	(6,1%)
					Average other currency zones	**(0,4%)**	**3,9%**
					Overall average	**(0,4%)**	**4,6%**

Inflation expectations slightly lower

Long-term inflation rate expectations decreased slightly since year-end 2019. In the Eurozone, consumer price-based inflation is still on par with year-end 2019 after increasing 20bp these last two months, while the retail price index in the UK has dropped 10bp over 2020.
A lower inflation rate generally decreases inflation-dependent liabilities. Although the actual impact will be subject to the benefit plans valued.

Based on a survey among professional forecasters, the European Central Bank has raised in Q4-2020 its 5 years ahead inflation forecast back to the year-end 2019 level, although it remains significantly higher than the markets' implied inflation expectations.

	Selected	Inflation rate				Year-to-date
	duration[1]	31-Dec-18	31-Dec-19	30-Nov-20	31-Dec-20	increase/ (decrease)
Eurozone CPI[2]	15	1,7%	1,4%	1,3%	1,4%	0,0%
UK RPI[2]	20	3,4%	3,2%	3,2%	3,1%	(0,1%)
ECB longterm target for Eurozone		*1,9%*	*1,7%*	*1,7%*	*1,7%*	*0,0%*

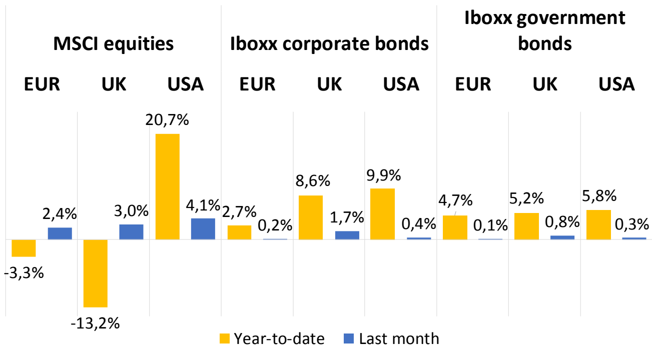
We note that UK government confirmed in November that as from 2030 RPI will be aligned with CPIH (CPI incl. housing costs). This might impact UK pension liabilities, as pension increase assumptions are typically derived from RPI.

Bonds up, but equities mixed in 2020

For funded liabilities the situation can be different. The Covid-19 panic caused a large-scale sale of equities and corporate bonds in Q1-2020. Since then, many markets made a significant recovery.

Global equity and corporate bond indices performed strongly in the last two months of 2020. Nevertheless, the year-to-date equity returns are still negative in Europe and UK. This implies that funded liabilities could still be under additional pressure, compared to unfunded liabilities, if they are heavily weighted toward Eurozone or UK equities.

Equity and bond returns 31-Dec-2019 until 31-Dec-2020
(Year-to-date and Last month returns)



Looking ahead

The reaction of governments and central banks on Covid-19 has steadied bond and equity markets around the world. In November US election outcome and successful Covid-19 vaccine trials pushed most asset returns strongly upwards. In December markets applauded the first Covid-19 vaccines being administered, and a no-deal Brexit being avoided.

Market uncertainty remains in the short term, with many countries seeing a strong rise in Covid-19 cases, more contagious virus variants emerging and limited vaccine availability becoming apparent. New lockdown measures seem inevitable.

In the longer-term uncertainty remains about the evolution of the virus, impact of vaccines, economic recovery, and consequences of large government budget deficits that have been created while fighting the pandemic.

Companies should therefore closely monitor the evolution of discount rates and asset returns over the next months. Aon can help mitigate your company's exposure to balance sheet liabilities, for instance by giving advice on discount rates and other assumptions, investigating the possibility to settle your company's liabilities, or reviewing funding options. If you would like help on this feel free to contact your Aon consultant.

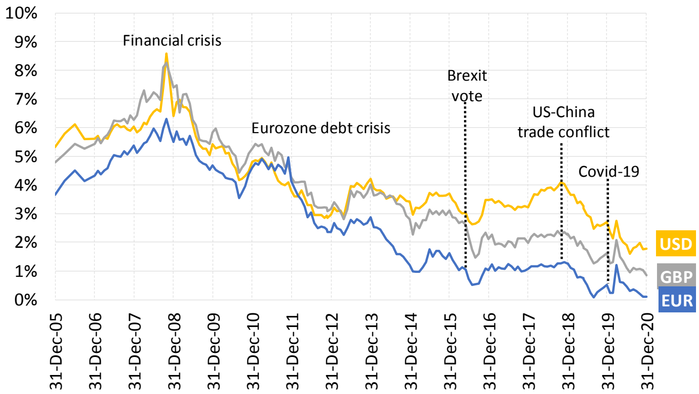
Background information

Employee benefit liabilities under IFRS and US GAAP accounting are calculated as the present value of your company's future pension obligations, adjusted for any available assets in an external funding vehicle. This present value is based on a discount rate derived from the yields on high quality corporate bonds with durations similar to that of these obligations, or on government bond yields if the corporate bond yield market is not deep enough.

What balance sheet impact your company can expect from a change in discount rate, depends on several factors. Important are the regional spread of your company, the duration profile of the liabilities and the size of the discount rate change. Also, other financial and demographic assumptions and the return on any available assets impact the liability.

Over the last decade discount rates showed a steady drop in most major currency zones, mainly caused by central banks' measures to avoid a global recession. In 2019 discount rates had dropped on average 70bp due to the escalating trade conflict between the USA and China, interest rate cuts by central banks and the fear of a global economic slowdown or recession.

Discount rate evolution 31-Dec-2005 until 31-Dec-2020 (in %)
(Merrill Lynch Corporate AA bond yields for duration of 10 years)



Data sources

Discount rate and inflation rate

For the main currency zones a single equivalent rate was derived from the yield curve using cash flows representative for employee benefits in these markets. For the other currency zones, the rate was selected from the yield curve for a duration of 10 years. All rates were rounded to the nearest 10bp.

Main currency zones – Yield curve source for the discount rate	
USA	Aon US corporate AA bond universe curve
Eurozone	Aon Eurozone corporate AA curve
UK	Aon UK single agency corporate only AA curve
Canada	Aon Canadian new AA curve
Japan	Aon Japanese curve
Switzerland	Aon Swiss corporate AA bond curve

Other currency zones – Yield curve source for the discount rate	
Australia	G100 discount rate curve (milliman.com)
Brazil	Government bond rates (NTN-B, anbima.com.br)
Czechia	10y government bond yield (investing.com)
India	Zero coupon sovereign rupee yield curve (ccilindia.com)
Mexico	10y government bond yield (scotiabank.com.mx)
New Zealand	Risk-free discount rate for accounting valuation (treasury.govt.nz) (3)
Norway	Discount rate for corporate bonds (regnskapsstiftelsen.no) (3)
Poland	Government bond rates (bondspot.pl)
South Africa	Nominal zero coupon bond yield curve (iress.com)
South Korea	Corporate AA bond yields (kis-net.kr)
Sweden	Aon Swedish mortgage bond yield curve
Taiwan	Government bond index report (tpex.org)
Thailand	Zero coupon government bond yield curve (thaibma.or.th)
Turkey	Government bond rates (Bloomberg)

Main currency zones – Yield curve source for the inflation rate	
Eurozone	Aon Eurozone inflation swap curve
UK	Aon UK market implied break-even rate curve

Asset return

Equity returns are based on MSCI net index evolution data published on investing.com. Corporate bond returns are based on total return index level data for the iBoxx investment grade corporate bonds as published on markit.com, and for government bond returns this is based on their investment grade sovereign and sub-sovereign bonds data. For USA, only the domestic bonds were considered. For UK, only non-gilts data was considered.

Notes

(1) Selected duration for major currency zones is based on the average observed duration of employee benefit liabilities in Aon's Global Survey of Retirement Plan Accounting Assumptions and is 10 years for others.

(2) CPI: consumer price index, RPI: retail price index.

(3) The discount rate for these countries is only published a few times per year. The most recent rate at the date of publication is reflected in this document.

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The global retirement landscape is evolving at a rapid pace. Combinations of legislative, political and economic change pose both significant threats and create significant opportunities for DB and DC pension schemes. Setting and executing a successful global retirement strategy is therefore essential to managing potential risks; from effective benefits design and global mobility arrangements to the governance of financial and operational decision-making on a local, regional and multinational scale.

Aon’s market-leading capabilities make us the perfect partner to help you through your unique multi-country pension challenges. Our international expertise across our broad portfolio enables us to provide integrated and comprehensive solutions, from the management of global retirement plans to the co-ordination of local retirement services. However large or small our clients’ needs, we can help to empower results every step of the way.

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